

Sustainable Investments in the Insurance Sector*

Viktória Deák – Nikolett Törös-Barczel – Norbert Holczinger – Ferenc Szebelédi

Achieving global environmental and climate agreements requires the efforts of not only supranational organisations and states, but also the financial sector, including the insurance sector. In addition to the core business of insurance companies, i.e. the undertaking of risk, their investments also play a key role. Recent years have seen an increasing number of unit-linked products that seek to contribute to some sustainability goal. However, the sustainability approaches and investor disclosures of collective investment undertakings and unit-linked asset funds have not been uniform, warranting regulation on account of the growing risk of greenwashing. New EU legislation has created the opportunity, inter alia, to distinguish collective investment undertakings and asset funds in terms of sustainability and to ensure greater transparency for investors. While there is no doubt about the need for regulation, at this stage it poses a number of challenges for institutions.

Journal of Economic Literature (JEL) codes: G22, G32, K29, Q56

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1. Introduction

Today, in all walks of life our encounters with sustainability are becoming ever more frequent. This is no different in the financial sector as well, where the issue appears in a number of aspects. These include, on the one hand, the risks posed by climate change to the operation of various financial institutions (*NGFS 2019, 2020, 2022; BIS–BDF 2020*), and on the other hand, the means and extent to which the financial system itself can influence climate risks and how it can participate in mitigating climate change and its consequences.

* The papers in this issue contain the views of the authors which are not necessarily the same as the official views of the Magyar Nemzeti Bank.

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Along with central banks and supervisory authorities, regulators play a key role in greening the financial sector, as exemplified by the European Union's actions in recent years (*UN Environment Inquiry 2018; Dikau – Volz 2019; Matolcsy 2022*). Following the EU's ratification of the UN Paris Climate Agreement in 2016, a High-level Expert Group (*HLEG*) was created the same year to prepare comprehensive reforms. The Group identified two avenues: to enhance the role of the financial sector in sustainable growth and addressing climate risks, and to strengthen financial stability with environmental, social and corporate governance aspects¹ in mind (*HLEG 2017*). The Sustainable Finance Action Plan published in 2018 sets three objectives: to steer capital flows towards sustainable investments, to address financial risks arising from climate change and to increase transparency (*DG FISMA 2018, Veerle 2020*).

Sustainability challenges may also open up business opportunities for financial market participants, including the insurance sector, which have the ability to reallocate, through their investments, capital from high-emissions economic activity to low-emissions, climate-friendly projects, helping to achieve the environmental goals in the process. According to a recent IMF analysis, the achievement of the objectives set out in the global climate agreement would require an annual USD 3–6 trillion globally up to 2050, which cannot be covered by resources from public finances alone; therefore, the financial sector is needed to finance sustainable investments and economic activities (*Prasad et al. 2022*).

Among financial market participants, insurers can be seen as being in a special situation also on account of their multifaceted exposure to sustainability risks: as undertakings, as risk-takers, as risk managers and as investors (*UNEPFI 2012*). This is especially true in the case of climate risks, which, in our experience, have recently gained prominence among such risks. In itself, the management of environmental risks is not new to the insurance sector, as a significant part of insurance risks are covered to offer protection against negative environmental impacts (e.g. storms, floods, droughts, etc.). The issue of financial risks arising from climate change was already actively addressed at the international level by the insurance sector (as well as by reinsurance, with an even larger information base) the late 2000s, and thus later on the first climate models were set up mainly relying on data from insurers (*Pandurics – Szalai 2017*).

The International Association of Insurance Supervisors (IAIS) has addressed the relationship between insurers and ESG risks (especially climate risks) in several publications (*IAIS 2018, 2020*). Based on these studies, and on the presentation of impacts in the UK (*BoE 2015*) and those potentially occurring in Hungary (*Pandurics – Szalai 2017*), it can be concluded that the insurance sector is exposed to both

¹ ESG.

physical and transition risks, which are accompanied by liability risks. In addition to their impact on the assets and property insured, physical risks can also affect mortality and demographic trends, and may thus occur in the case of both life and non-life insurance. They may also be sources of investment risk, as changing climate or specific natural events may have a negative impact on the value of insurer assets. Transition risks primarily involve an investment risk, whereas a good example of liability risks is the potential loss resulting from business operations that ignore climate risks.

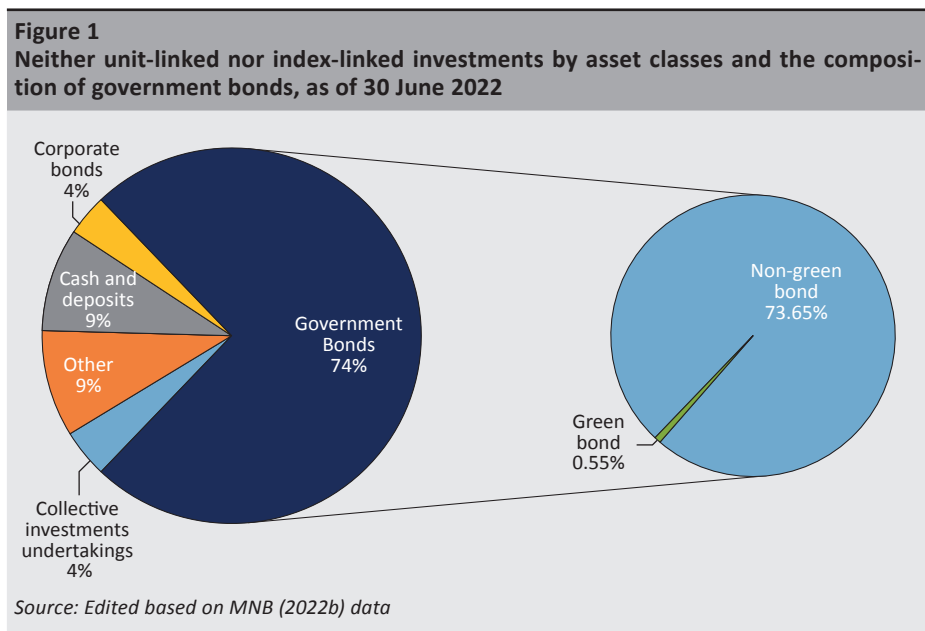
Looking at these risks from a different perspective, it can be established that insurers' risk-taking (i.e. what the institution does or does not cover) and their investment activity are both highly exposed to sustainability risks. In view of the broad scope of the subject, our study is only concerned with investment aspects, with a particular focus on unit-linked insurance. Investment activity can be divided into several parts, with a distinction being made between assets in terms of whether investment risk is primarily taken by the insurer or by customers. The former category includes, amongst other things, assets covering the reserves of traditional life insurance products,² while the latter essentially comprises unit-linked life insurance, where the customer can determine where their savings are to be invested by choosing from the asset funds offered by the insurer. Due to the nature of the plan, the number and characteristics of investment options available during the decision-making process are decisive, i.e. the options provided by the insurer and the amount of information available on the asset funds offered. The latter may also be referred to as a transparency criterion, which already played a prominent role in Hungary as part of regulating ethical life insurance, primarily by increasing the transparency of costs (*Mátyás et al. 2017*). The transparency of the sustainability characteristics of investments is provided for by recently issued EU legislation.

This paper examines the impact of European legislation on sustainability disclosures. For that purpose, we first review the characteristics of the investments of Hungarian insurers and then present the Hungarian sustainable asset funds, with a special reference to the possible difference on the cost side compared to 'traditional' asset funds. After presenting the main points of EU regulations, we examine practical issues as well, with a particular focus on the tasks related to the product management system.

² In the case of traditional savings life insurance products, due to the return of excess return, the service of the insurer also depends on the return on investment, whereby the customer also bears an investment risk.

2. Overview of Hungarian insurers' investments

To a large degree, insurers can exert their impact on climate change through their investments. The analysis of asset composition is a possible method for determining the commitment of the insurance sector to sustainability. Insurer assets can be divided into two large groups according to whether the primary risk-bearer is the customer (unit-linked) or the insurer (non-unit-linked). Non-unit-linked assets include own assets, collateral for non-life reserves and collateral for life insurance reserves (excluding unit-linked). In turn, unit-linked assets comprise unit-linked reserves, with approximately one half of the assets falling into each of the two groups (MNB 2022b). While the latter is explored in detail in the subsequent sections, the following paragraphs provide an overview of non-unit-linked assets.



Approximately three quarters of the non-unit-linked assets of Hungarian insurers are government bonds (Figure 1), comprised predominantly of Hungarian and, to a lesser extent, other European Union exposures. It is worth examining the proportion of green government bonds among these. Providing finance for green projects, green government securities have a dynamically developing market all over the world (Banga 2018). This is no different in Hungary, where they represent one of the sources of climate neutrality, to be achieved by 2050 (Government Debt Management Agency 2020). In contrast to the high proportion of Hungarian government securities, Hungarian green government bonds represent a mere 0.55 per cent of all non-unit-linked assets. A similar result is obtained by examining the

proportion of Hungarian green securities only among long-term government bonds: of all government bonds maturing between 2032 and 2051, only 3.57 per cent are green. The most important reason for this low presence is that in Hungary, green government securities were first issued in June 2020, denominated in EUR, and were only followed by a HUF-based issue in April 2021. Thus, up to the reference date of our analysis (30 June 2022), insurers only had a short period of time to purchase these instruments. Another reason is that green government bonds are only available for three maturities (2032, 2035 and 2051), which significantly reduces the investment opportunities.

In addition to green government securities, insurers also hold green corporate bonds in their portfolios. While their aggregate share of non-unit-linked assets is less than 0.1 per cent, it is worth adding that corporate bonds also account for only 4 per cent of the total. Overall, therefore, the presence of green and sustainable assets within non-unit-linked assets is minimal, even for insurers with a higher share of unit-linked assets in their sustainable investment asset funds.

3. The emergence of sustainable asset funds and the analysis of empirical data from Hungary

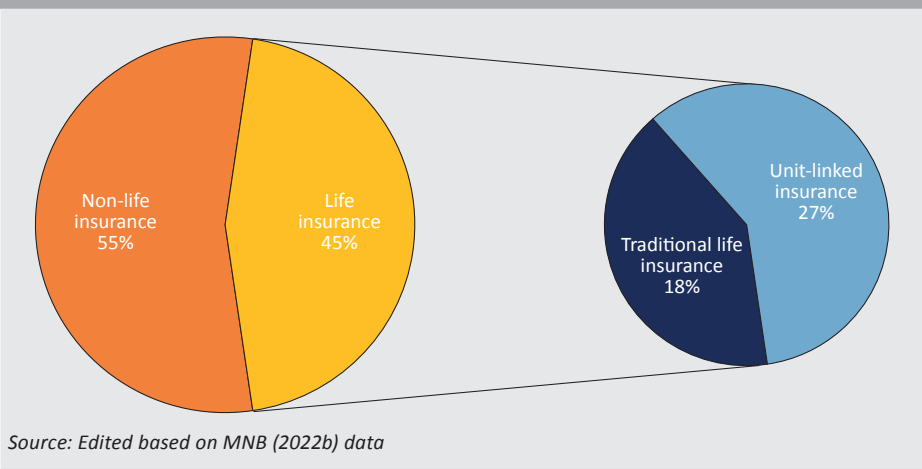
As noted above, the insurance sector has a significant role to play in supporting the transition to a sustainable economy. It is an often-mentioned fact that resources from public finances alone cannot provide the funds required for the investments to achieve the environmental and climate objectives, and therefore the involvement of the financial sector, such as banks, insurers, fund managers, investment firms and funds, is essential for the transition to a low-carbon economy (*DG Trésor 2017*). The insurance sector also plays an important role in channelling capital towards sustainable investments via insurance-based investment products (IBIPs). Of these, unit-linked insurance products are examined in detail, which combine the services offered by life insurance and collective investment undertakings, so that the amount of payments due on maturity or in the event of death is determined by the return of the investment funds selected by the customer. In addition to their goals to drive returns, the asset funds associated with insurance products have recently incorporated sustainability criteria as well. Accordingly, the amount paid by the policyholder can be transferred, at their request, to a fund that indirectly provides financing for climate-friendly or other sustainable investments.

On the European stage, collective investment undertakings contributing to sustainability and green goals emerged from the early 2010s. *Morningstar (2020)* reports on the exponential growth of European sustainable funds and notes that in 2020, despite the coronavirus pandemic, sustainable investment funds worth a record amount of more than one trillion EUR were available in the European

capital market, reflecting a 52 per cent increase in assets compared to the previous year. One of the reasons for this may be that, in addition to the increasing sustainability needs of investors, ESG investments were regarded by many as a safe haven (Singh 2020). Another possible contribution may have been the abundance of money that was characteristic of the period, owing in part to the involuntary savings caused by the pandemic and in part to the availability of state income transfers. However, due to data availability problems, it is not possible to determine exactly how much of the value of the funds can be associated with unit-linked insurance products. The survey does note though that sustainable investment funds cover a very broad universe, with multiple shades of ‘sustainability’ along a wide range of investment strategies. Depending on the approach followed, a distinction can therefore be made e.g. between so-called ESG, SDG,³ green, climate, sustainable, thematic and impact investments (Morningstar 2020). This warrants attention also because the different methodologies may assume very different effects in terms of their contribution to sustainability goals.

However, as regards the Hungarian insurance sector today we have a more accurate picture of the size and context of the assets managed in the unit-linked insurance products marketed in Hungary.

Figure 2
Premium received by insurance companies (except for small insurance unions), by product group (2021)



³ Sustainable Development Goals – sets out the UN’s Sustainable Development Goals.

Unit-linked insurance products account for more than half of the share of life products, representing a sizeable slice within the range of insurance products. In 2021, the premium income of insurance companies from unit-linked insurance exceeded HUF 356 billion, which is 27 per cent (*Figure 2*) of the total premium income of insurers (life and non-life combined). As in developed international markets – although much later, around 2018 – Hungary also saw the emergence of unit-linked insurance products where some of the underlying investment options concerned environmental and social objectives. Their value exceeded HUF 22 billion by the end of 2020, a minute share amounting to a mere 1.7 per cent⁴ of the total assets of Hungarian unit-linked funds. In addition, only HUF 1.3 billion worth of the assets managed in sustainable asset funds were allocated to Hungarian collective investment undertakings (*MNB 2021*).

In the absence of an official classification and definition set, before 2021 Hungarian sustainable asset funds could only be identified using keyword searches in fund names. The question immediately arises as to the extent to which, in the absence of appropriate and uniform regulation, the ESG or sustainable investment products based on self-qualification meet the sustainability goals promoted in their names and investment objectives, and contribute effectively to the promotion of environmental goals. As these financial instruments were not certified for a long time by any independent third party, the risk of ‘greenwashing’ also arose in the capital markets. The term essentially refers to situations where a company develops an environmentally friendly image without meaningful activity in that regard⁵ (*Cambridge Dictionary 2022*).

Recognising the need for regulation, the European Union’s Sustainable Finance Disclosures Regulation (SFDR)⁶ for investment service providers entered into force in March 2021, which not only helps investors and consumers to make their investments as transparent as possible, but also enables financial products to be ‘categorised’⁷ according to the depth of the sustainability goals. In this context, a distinction can be made between three types of collective investment undertaking, or, in this case, asset fund: (a) products complying only with Article 6 of the SFDR, which do not have a sustainability objective and can therefore be considered as traditional investments; (b) products complying with Article 8 of the SFDR, which aim to promote environmental and social aspects while following good corporate governance practices (ESG); and (c) products complying with Article 9 of the SFDR,

⁴ In Hungary, the investments underlying unit-linked insurance products are essentially asset funds, which are typically composed of the Hungarian and foreign investment funds of the related institutions, and, in contrast with international practices, do not make individual direct investments (*MNB 2021*).

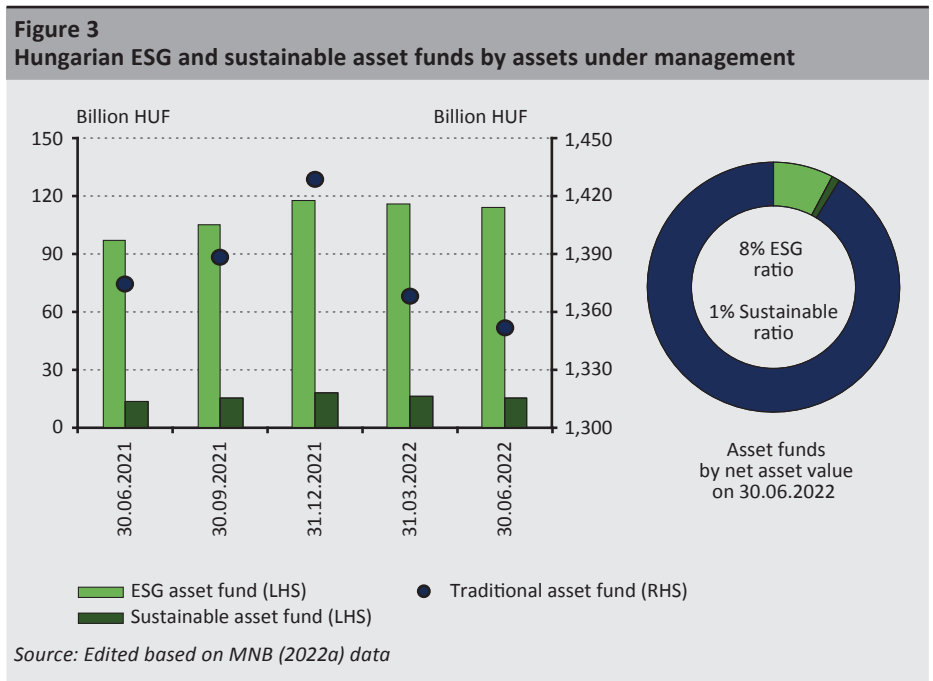
⁵ Cambridge Dictionary (2022): Meaning of greenwashing in English. <https://dictionary.cambridge.org/dictionary/english/greenwashing>. Downloaded: 15 September 2022.

⁶ Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

⁷ Although SFDR is primarily a disclosures regulation, it is useful for a better understanding of the main differences between products.

which aim to achieve sustainable investments. The uniform classification has created a more accurate picture of the sustainability of EU and Hungarian investments, and can serve as a reference point for customers to choose, from the given repertoire, the asset fund that is appropriate for their sustainability preference.

After the entry into force of the Regulation, the stock of assets managed in the asset funds complying with SFDR Articles 8 and 9 increased compared to the earlier estimated HUF 22 billion, indicating, among other things, the launch of new asset funds around sustainable themes, in addition to the asset funds previously self-styled as ESG, green, sustainable, etc. (Figure 3). That said, some of them may not have pursued a sustainability goal before, but changed direction by rethinking their investment strategies, and had themselves reclassified into one of the SFDR categories in accordance with the Regulation. Based on data from the MNB, by the end of the first half of 2022, of the asset funds underlying unit-linked insurance products available to clients, 56 integrated environmental and social aspects and 7 contributed to sustainability goals. Their combined net asset value exceeded HUF 130 billion, which is 9 per cent of the assets held in the Hungarian multi-asset portfolio.



In almost a year and a half, therefore, the assets of ESG or unit-linked asset funds identified in Hungary have increased more than fivefold. This may be due in part to previous estimation constraints along with the entry into force of the SFDR Regulation, which enabled the visibility of investment products that had already

existed and followed a sustainability policy, and in part to the recognition of increased investor demand, social demand and sustainability risks, and thus the integration of management methods in investment decision-making.

The popularity of asset funds complying with SFDR Articles 8 and 9 depends on a number of factors: on the one hand, the risk preference of the counterparty must meet the degree of risk associated with the fund, and on the other hand, the expected return must also be delivered. Although it is currently difficult to draw far-reaching conclusions on the performance of sustainable investments, which are mostly influenced by the markets, the insurer may also influence it through cost reductions, whereby the cost indicator provides the means of a financial comparison between ESG funds and traditional asset funds.

Under the *Insurance Act*⁸ and the *MNB decree on the calculation and publication of the annual cost indicator*⁹, insurers are required to publish the annual cost indicator (ACR) associated with each savings life insurance product. This will help consumers, for whom the cost of insurance offered by different insurers will become transparent. The ACR shows the approximate amount of return the insurer draws from the customer compared to the cost-free state, subject to predefined parameters. Its primary objective is to inform customers and ensure the comparability of insurance products. The ACR incorporates all costs incurred in connection with the product, including asset management costs for unit-linked insurance. Accordingly, for the same unit-linked insurance product, selecting different asset funds may cause variations in the ACR due to the different asset management fees.

Table 1		
Average ACR for asset funds complying with SFDR Articles 8 and 9, and average ACR within the same product for a term of 20 years		
	Average ACR for asset funds complying with SFDR Articles 8 and 9 (%)	Average ACR per product (%)
Insurer A	3.32	3.10
Insurer B	3.50	3.41
Insurer C	3.17	3.21
Insurer D	3.37	3.20
Insurer E	2.09	1.76
Insurer F	3.17	3.17
Insurer G	3.25	2.84

Source: Edited on the basis of MNB data

⁸ Act LXXXVIII of 2014 on the Insurance Business [Insurance Act]

⁹ MNB Decree No 55/2015 (XII. 22.) on the definition, calculation and publication of the annual cost indicator

The Hungarian market shows variations in the asset management costs associated with asset funds (*Table 1*), which, incorporated into the ACR, reduce the return on the asset funds, effectively drawing returns away from customers. On average, most Hungarian insurers charge higher asset management costs for asset funds complying with SFDR Articles 8 and 9 (see *Table 1*). However, there are rather large differences between individual insurers, with ACRs on ESG asset funds an average 5–6 per cent higher than the average cost indicator of the same product, which could translate into a difference of 15–25 basis points. In some cases, the cost indicator is up to 14–19 per cent higher, possibly resulting in a difference of 30–40 basis points. Trends for unit-linked insurance are different in the EU, where it is generally accepted that the RIY indicator¹⁰ (which is similar to the ACR) is the same as the cost indicator for ESG-rated asset funds (*EIOPA 2022*).

Naturally, this does not mean that the above claim would apply to all asset funds, as averaging conceals asset funds that the client chooses to obtain a lower ACR compared to the rest of the asset funds.

Overall, in the majority of cases, the ACR (i.e. the cost of asset management) is higher for ESG funds, which can be attributed to the following factors: Compiling an ESG asset fund essentially requires more research work, since in addition to the ‘usual’ parameters, so-called sustainability strategies also tend to get thrown into the mix and must be taken into account when selecting assets. Moreover, a new asset fund needs time to become popular and increase its net asset value along the way, which, especially at the beginning, makes it a more costly project that requires more attention. It should be noted, however, this mainly concerns asset funds complying with SFDR Article 9, whereas in the case of SFDR Article 8, which provides for a more relaxed set of conditions, less effort is required to transform an existing fund into a more sustainable one, allowing initial difficulties to be overcome. Furthermore, the insurer may also price in the increased interest in the product, i.e. higher demand may in itself be a driver of higher ACR.

That said, the extra expenses incurred on the fund manager’s side may also be accompanied by a higher distribution budget. The person distributing and recommending the asset fund must be adequately prepared, as many customers are new to ESG and unaware of its advantages and disadvantages, and the promotion of such may warrant additional advertising costs.

These elements are relatively easy to quantify, but there may also be factors without any actual underlying activity, such as the customer’s commitment. More dedicated customers may be willing to pay more for a product solely on the grounds that it better fits their preferences. In addition, climate change is now a very important

¹⁰ Reduction in Yield

issue that concerns many people, so even the increased interest that it has attracted may lead to a specific price increase.

In any case, it can be clearly seen that as fund managers are adding new ESG-like and sustainable funds to their range that also comply with the SFDR, within the insurance sector prominence is being given to more sustainable asset funds available within the limits of unit-linked insurance.

4. Significance of the entry into force of the SFDR and its implementation into the operation of investment units linked to life insurance

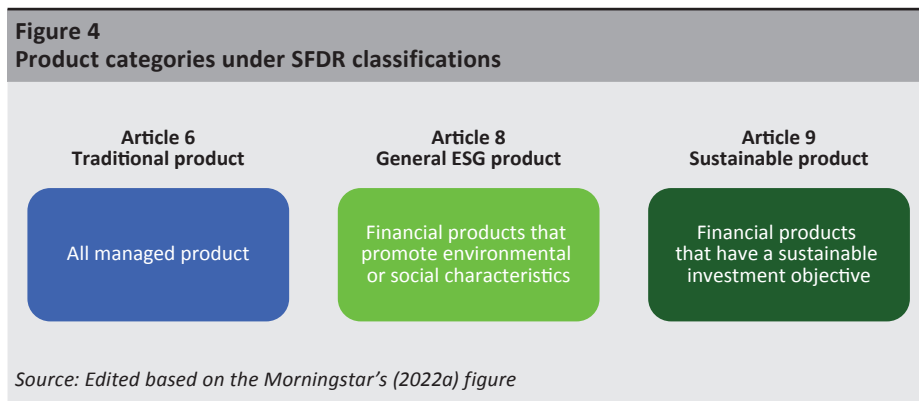
As mentioned above, in the past decade a number of financial solutions have emerged that represented varying levels of sustainability or environmental goals. In the investment services sector, however, the sustainability approaches to this type of financial instrument, but in particular the disclosures addressed to investors, were not standardised, as this area had not previously been subject to harmonised requirements. Inconsistent disclosure standards, on the other hand, make the comparability of different financial instruments more difficult, may imply an unlevel playing field, and may confuse investors' decisions. In addition, the adverse impacts of intensifying climate change and other environmental and social problems constitute a new type of risk, not only to the economy, but also to the financial sector. This is the sustainability risk mentioned above, which, if ignored, could negatively affect financial market participants. In response to the major inconsistencies in established disclosure practices and in order to incorporate sustainability risks into the investment decision-making process, the first-level rules¹¹ of the SFDR entered into force in March 2021. The Regulation applies to collective investment undertakings, insurance asset funds and pension funds, among other vehicles. The main objectives of the SFDR are to ensure:

- that financial market participants and financial advisers integrate sustainability risks into investment decision-making policies,
- that financial products take into account adverse impacts in terms of sustainability,
- an increase in transparency in relation to the sustainability features of financial products, curbing the risk of greenwashing activities and fostering the development of responsible and sustainable investments.

The Regulation therefore helps to provide broader access to information for investment decisions and allows a distinction to be made (*Figure 4*) between

¹¹ The Regulation can be interpreted at two levels, with basic requirements set at the first level, for which the technical and formal criteria are provided by second-level rules (*Commission Delegated Regulation (EU) No 2022/1288 – SFDR RTS*). The SFDR RTS will apply from 1 January 2023.

investments that promote environmental or social characteristics (SFDR Article 8 products) and those designed to make a positive impact on the environment and society (SFDR Article 9 products).



The higher the sustainability ambition of an investment product, the more detailed and accurate disclosure is required of statements on financial instruments such as investment funds or asset funds. In general, all investment products covered by the Regulation are required to integrate sustainability risks into investment decision-making, which is therefore a minimum that should be met regardless of the level of sustainability ambitions. However, for ESG-like and sustainable financial products, in this case asset funds, additional information is required under the Regulation, which essentially ensures that such investments actually fulfil the environmental and social goals promoted in their names and stated objectives. In practice, a number of methods have been developed to promote sustainability characteristics and to manage adverse impacts on sustainability factors, which will be explained below.

4.1. Integrating sustainability risks into investment decision-making

Sustainability risk is defined in *Regulation (EU) 2019/2088* as “an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment”. Sustainability risks have not been part of risk management in the past, but recent research has convinced financial sector participants that such risks, resulting e.g. from adaptation procedures towards a low-carbon economy, can indeed be important for investment performance (BoE 2018). Such developments may also result from the European Union’s increasingly tight climate policy (introduction of a carbon tax) or from social expectations (investor demand for environmentally friendly companies). Sustainability risks therefore jeopardise the stability of the capital market, making their implementation in the risk management system indispensable for financial

market participants, which, therefore, definitely affects the insurance sector as well (Gatzert *et al.* 2020).

In order to comply with the requirements of the Regulation on the integration of sustainability risks, investment units linked to insurance must have a defined methodology according to which they are taken into account in investment decisions. On the other hand, investment service providers should provide information on the effect of such risks on the return on investment. According to the Regulation, where sustainability risk is not considered relevant by financial market participants, they should provide a clear explanation of the reasons for this. While Hungarian practice has no example to offer for investment where sustainability risks are not relevant, several ways have emerged of integrating them since the Regulation entered into force.

Regardless of the product category, risk management approaches frequently exclude from the investment universe companies that are heavily polluting or gravely violate human rights. The fund manager therefore establishes a so-called exclusion policy, which is taken into account when selecting investments. Exclusion or disqualification may be based on social expectations, but may also be underpinned by scientifically defined criteria. There may also be cases where the fund manager scores the issuers of the securities included in the investment scope against ESG criteria, e.g. their impact on these factors. It then ranks candidates to consider the risk of the given company from a sustainability perspective. However, this approach alone will not lead to the exclusion of specific investments, as it only involves the identification and inventory of risky investments. Although the SFDR requires that sustainability risks be taken into account, doing so will not always be followed up by action. Therefore, it is important to point out that risk mitigation methods must be used in order to avoid the negative impact of sustainability risks and thus to ensure the stable operation of financial products.

4.2. Disclosure of sustainability information

As explained earlier, the greater the sustainability ambition of an investment unit, the more detailed information must be disclosed to investors in order to ensure transparency and an appropriate investment decision. The SFDR sets out a separate requirement for investments aimed at promoting environmental and social characteristics and for those having an explicit objective of contributing effectively to a sustainability goal.

In the case of unit-linked asset funds that are intended to promote environmental and/or social characteristics and the companies selected for investment purposes follow good governance practices, the information required under Article 8 of the SFDR must be shared with investors. The method and details of this will

be determined by the SFDR RTS from 1 January 2023. The Regulation requires a description of how these aspects are implemented. In practice, therefore, financial service providers are required to define a transparent sustainability strategy at the product level to ensure that the objectives set are met. In its report, the *MNB (2022a)* presents the sustainability strategies most commonly applied by Hungarian institutions based on experience to date. These include, amongst others, negative and positive screening, ESG integration, and ESG index tracking,¹² which are presented in more detail in *Table 2*.

Asset funds seeking to implement sustainable investment must share with investors the information required by Article 9 of the SFDR, which will also be set out in the RTS from the beginning of 2023. In this case again, the Regulation requires a description of how that objective is to be achieved, but also requires additional and more specific and concrete information to be disclosed; for example, where a fund seeks to reduce CO₂ emissions, in addition to how this is accomplished the reduction target to be met must also be provided in alignment with the achievement of the long-term objectives related to global warming as set out in the Paris Agreement. Asset funds implementing sustainable investments must also have a sustainability strategy, which can be based on the approaches mentioned above, but requires much more stringent terms, as such financial solutions can only deliver sustainable investments. According to Regulation (EU) No 2019/2088, a sustainable investment may be “*an investment in an economic activity that contributes to an environmental objective*” (e.g. activities related to renewable energy, water management, waste management, greenhouse gas emissions or biodiversity), or “*an investment in an economic activity that contributes to a social objective*” (e.g. an investment that contributes to tackling inequality or that fosters labour relations, or an investment in human capital or economically or socially disadvantaged communities). Sustainable investments should also fulfil additional criteria, i.e. such investments must not significantly harm any of the objectives listed in the Regulation, and the investee companies must follow good governance practices.

¹² The list is not exhaustive.

Table 2				
Most frequently used sustainability strategies by SFDR compliant product category				
Sustainable strategies	Short description	Article 6	Article 8	Article 9
<i>Negative screening/ Exclusion policy</i>	Aimed at avoiding emitters or entire industries that are harmful to the environment and society, primarily on a standard basis.	X	X	X
<i>ESG integration</i>	Incorporation of ESG criteria in analyses and decision-making processes. Uses a scoring method to measure the ESG performance of issuers in the investment universe.	X	X	X
<i>Positive screening</i>	Positively discriminates socially responsible and environmentally sustainable companies when selecting investments.		X	X
<i>ESG screening (Positive/ negative)</i>	Ranks companies based on their ESG scores, then excludes the assets of the companies with the poorest ESG scores, promoting the best-performing companies, even on a best-in-class basis.		X	X
<i>Green/ESG index tracking</i>	Essentially tracks the index basket partly or fully.		X	X
<i>Thematic investment</i>	Invests in companies whose activities cover an area of sustainable development (e.g. entities performing various activities related to sustainable water management).			X
<i>Impact investment</i>	Invests in companies that, through their activities, have a positive impact on the environment and society (e.g. renewable energy, electromobility, sustainable agriculture).			X

Note: When scoring, the financial market participant evaluates the extent to which the company enforces or influences certain environmental, social and governance factors in its operations (MNB 2022a).

Source: Edited based on MNB (2022a)

In general, fund managers in Hungary use more than one of these strategies at the same time, which can be considered as a good practice to ensure the achievement of the set objectives and meet investors' sustainability preferences. The more strategies financial market participants use, the more certainly the investment will promote environmental or social characteristics and avoid greenwashing (MNB 2022a).

As regards investment funds, only one product has been created in Hungary to date that is sustainable within the meaning of the Regulation, i.e. falls into a category under Article 9; however, some of the current unit-linked asset funds can already be classified as sustainable financial products, since the underlying foreign investment funds in which they invest meet the standards.

The main difference between the two categories is therefore that the ESG funds encourage the responsible operations of issuing companies (e.g. improving energy efficiency in the production line, employee treatment) by comparing the impact of organisations on the environment and society. Ultimately, by doing so they indirectly help to achieve environmental and social objectives, whereas sustainable funds contribute more directly to climate change mitigation, for example, through sustainable investments (e.g. solar power plant investment, circular resource management). Obviously, the Regulation allows SFDR Article 8 compliant products to implement sustainable investments, enhancing the differentiation of financial products on a 'sustainability scale'. This is made possible by the EU Taxonomy Regulation,¹³ which complements the SFDR by defining environmentally sustainable economic activities. The precise information and ratios relating to these should be made clear in disclosures to investors.

4.3. Consideration of adverse impacts on sustainability factors

Another important provision of the SFDR, irrespective of the investment objective, encourages the investment services sector to consider, in terms of the return on their investments, not only sustainability risks but also the extent to which the operation of a fund may indirectly adversely affect certain environmental and social factors (e.g. biodiversity). Although below a certain number of employees the Regulation does not require a focus on adverse sustainability effects, an inventory of adverse impacts must nevertheless specify for investors the way in which such negative effects are considered. Similarly to the management of sustainability risks, when inventory is taken of adverse impacts, the adoption of an exclusion policy may be a good practice, since the exclusion of an environmentally harmful emitter from the investment scope could reduce environmental pollution. While they should not be confused, the two concepts are interrelated, given that a company with a significant adverse impact will have its operations more exposed e.g. to stricter environmental policy regulations, fines and consumer disengagement, i.e. a major sustainability risk. The adverse impact on sustainability factors can be measured through a number of indicators, which will also need to be applied and made public by financial actors in the near future, and will better highlight the sustainability of investments.

¹³ Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

5. Relationship between SFDR and product oversight and governance requirements

In addition to the publication of the SFDR Regulation, there have also been other important changes in EU legislation concerning the characteristics of the insurance sector and the threefold objective of the action plan mentioned in the introduction. First, the Delegated Regulation accompanying the Solvency II Directive, which includes the prudential and capital requirements for insurers, has been revised¹⁴ to define the concepts of sustainability risk, factors and preferences and, in relation to investments, requires that the risks arising from sustainability should also be identified and addressed. Insurers are required to assess how their investments are affected by climate risks. Second, the Insurance Distribution Directive (IDD) and the related regulation have been amended.¹⁵ Essentially, these two acts take a customer-side approach to addressing essentially the same two aspects: how individuals' investments are affected by sustainability risk, and how they can enforce their sustainability preferences. It is in the context of savings life insurance that these questions are really relevant. Regulations on distribution are based on the definitions contained in the disclosure regulations. In the distribution process, needs assessment and suitability testing are key elements. In 2018, the EU Commission conducted a market consultation in which it assessed how the question of sustainability appears in suitability tests. Findings clearly showed that the investment objectives of clients were still generally related to financial objectives, while non-financial aspects (or those with only an indirect or longer-term financial impact), such as sustainability, were not present. A small group of customers proactively referred to sustainability as a preference (*Veerle 2020*). This may seem contradictory with the rise of green financial instruments, such as green bonds, but the latter's market is dominated by institutional investors, who base their investment decisions on a different set of criteria compared to retail investors.

The SFDR, which regulates the disclosure of sustainability information, combined with the Taxonomy Regulation, which sets out the classification criteria, allow investors, including buyers of insurance, to measure and understand the compliance of individual investments with ESG criteria.

Based on these, the new regulations require customers' sustainability preferences to be identified during needs assessment and suitability testing, and should also be taken into account during the distribution process of the products offered to them. The question of how financial and sustainability preferences are related emerged in

¹⁴ *Commission Delegated Regulation (EU) 2015/35*, the amendment applies from 2 August 2022

¹⁵ *Directive (EU) 2016/97 on insurance distribution, and Commission Delegated Regulation (EU) 2017/2359*

the context of capital market investments, which are subject to similar regulations. An ESG or sustainable product may also be suitable for a customer who does not otherwise have such a preference, but the opposite is not true. If the customer has indicated that criteria of ESG or greater sustainability are important to them, a product disregarding these will not be suitable. However, this does not mean that the customer has no return reference, that is, that they would be ready to forego higher returns in order to maximise their sustainability preferences.

The IDD introduced product oversight and governance arrangements in the field of insurance as well. This can be summarised briefly in the requirement for insurers to take into account customers' needs and interests during the development of their products and throughout their life cycle. Accordingly, they are required to identify the target group of the product, perform product testing based on scenario analysis with qualitative and quantitative elements before its launch, with subsequent reviews at appropriate intervals on the basis of actual performance. In 2021, in line with the trend referred to above, issues of sustainability also emerged in regulations for product governance arrangements. Consequently, sustainability criteria cannot be disregarded in product development and the necessary expertise must be ensured. At the same time, not all customers have sustainability preferences, and regulations do not make it impossible to meet such needs either. Participants in insurance distribution are obliged to notify the insurer in the same way as with other factors if the product no longer complies with the ESG criterion initially set.

6. Challenges for the insurance sector in the application of the SFDR

Although the main objective of the European Union's Sustainable Finance Disclosures Regulation was to increase the transparency and predictability of investment products traded on the EU capital market in order to eliminate 'greenwashing' and to ensure that the sustainability risks associated with these investments are taken into account, practical application has revealed numerous shortcomings and difficulties of the Regulation.

Basically, there are three types of challenges in terms of the regulations: functional challenges that arise when the regulations fail to deliver on their intended purpose, operational ones that concern challenges in its application, and ones that stem from the valuation methodology.

In terms of function, one shortcoming involves the development of sustainability strategies, which is not specified by the legislation itself. Thus, the most frequently used exclusion policy and ESG ranking often fails to fully screen out activities with harmful sustainability effects and selects e.g. only environmentally friendly and socially responsible investment assets to promote these characteristics. The

effectiveness of the exclusion strategy also depends on the width and depth of the segments it covers. For example, the environmental nature of negative screening that excludes from the investment universe only emitters involved in coal but not oil companies, is questionable.

One of the most critical points is the ESG classification of assets, i.e. the lack of a mature valuation methodology, and thus the regulations built on this already rest on a precarious footing. The essence of ESG ranking as a method for promoting sustainability criteria is to encourage companies to improve their environmental and social performance. In practice, however, the method is controversial, since the ESG score of financial instruments, i.e. the determination of how sustainable companies are on a given scale, may vary across reporting entities. This is explained by the fact that the weighting of each criterion is not known, and by the absence of a uniform ESG rating methodology that could clearly determine the level of sustainability of a company. This may give rise to a situation where various ESG rating companies award significantly different ratings to the same company, which reduces the credibility of the sustainability strategy based on this.

A survey by the European Securities and Markets Authority (ESMA) examined the situation of ESG data providers in the European Union and found, in addition to the above, that almost one half of the issuing companies cooperate with MSCI, ISS ESG and Morningstar Sustainalytics. Respondents also pointed out a number of shortcomings with regard to ratings, such as the lack of industry coverage or data granularity, while the use of ratings is fundamentally expensive, especially for smaller firms. From an ethical point of view, it is questionable that the company pays the rating company directly for the rating, and it can also request services from several rating institutions, which gives it the opportunity to choose the most preferred rating (*ESMA 2022*).

With ESG ratings, it is also important that investors who are committed to mitigating climate change consider the same thing to be sustainable as that underlying the assessment of the given company. This may raise the question of whether an oil company can be awarded a favourable ESG rating if, in addition to its clearly polluting core business, it also pursues ancillary activities that are socially beneficial and sustainable. In other words, can a single number capture the degree of sustainability along with environmental, social and government criteria?

The ESG rating should be unambiguous and, above all, uniform so that investors can place investment products on an objective sustainability scale. Regulation of the activity is therefore becoming increasingly urgent in order to ensure equal competition and protect investors, in particular against the risk of greenwashing. For the future, the plans are to make transparent and structured ESG databases

available, but in the meantime financial institutions will have to cope with initial difficulties.

Further valuation difficulties arise when instead of purchasing the securities of a single company, the customer seeks to invest in an asset fund which may comply with SFDR Article 8 or 9, or a traditional fund where no sustainability impact is involved, but these three categories do not specify the degree of sustainability of the asset fund as a whole. In an SFDR Article 8 asset fund, 80 per cent of the securities may promote environmental and social considerations, but that ratio may be as low as 10 per cent, and there is a huge gap between the two despite sharing the same name. It would be appropriate to indicate the precise extent to which an asset fund serves general ESG objectives (publication of which is expected to become compulsory from 1 January 2023). This is also important because a related amendment of the EU IDD provisions (from August 2022) has introduced the requirement to explicitly ask customers about their sustainability preferences and adapt the offer accordingly. In this way, the distribution process will also allow the customer to become familiar with the concepts and differences related to ESG and sustainability, which can further support their decision. In this sense, financial service providers, including insurers, also then fulfil an educational role.

Thus, one of the most important objectives of the SFDR remains to ensure transparency about sustainability characteristics and to eliminate ‘greenwashing’, which, based on what is seen in practice, is currently an increasing risk because regulations are incomplete or entirely absent. Greenwashing scandals not only jeopardise a company’s existence, but can also undermine confidence in the industry and its financiers.

From the point of view of operational challenges, the depth of integration of sustainability risks raises a number of questions, since the regulation does not in itself set a minimum requirement for the way in which the risks are integrated; accordingly, it cannot be ruled out that, although an investment service takes into account the sustainability risks, the policy applied in the course of investment decision-making is not effectively enforced. With regard to domestic investments, it can also be observed that if the given fund does not have objectives that promote ESG criteria or achieve sustainable investments, the method of integrating sustainability risks is less detailed than an investment with a sustainable objective. In practice, however, it is precisely those investments that will be most vulnerable to sustainability risks that will invest in the securities of companies whose activities are fundamentally polluting, such as those that are more exposed to increasing environmental policy regulations. Thus, logically, the more strategies promoting environmental and social objectives are incorporated into decision-making policy, the less the return on the asset base will be negatively affected by sustainability risk.

These concerns will be somewhat mitigated by the entry into force of the regulations on sustainable finance that are forthcoming or being amended (e.g. the Corporate Sustainability Reporting Directive (CSRD)¹⁶) and the entry into force of the supplementary regulatory technical standards (SFDR RTS) next year, so that, starting from 1 January 2023, financial services providers will be obliged to determine, for example, the proportion of investments they make in assets promoting environmental and social aspects and, where appropriate, the proportion of investments that are sustainable. This will provide investors with a more accurate picture of the sustainability level of certain funds compared to the current classification. At the same time, they will be obliged to measure the extent to which they can promote environmental and social characteristics year by year by using sustainability key performance indicators (KPIs). Where the adverse impacts on sustainability factors are also taken into account by the insurer, the measurement of these negative impacts must be presented annually, using predetermined KPIs. Examples of such KPIs include the carbon footprint of the operations, the greenhouse gas intensity of investee companies, the share of renewable energy consumption and production, or the exposure of energy-efficient real estate assets.

However, the greatest challenge to this is the collection of raw data, which, although it can be considered as a particularly good element of regulation, is still a problem for institutions. As this information is not yet fully available in the vast majority of cases, often only estimates can be relied on, which may introduce a significant bias relative to the actual situation. Furthermore, the methodology for calculating such performance indicators has not been specified or clarified, and internal resources are also needed to process this information. Mention must also be made of the fact that the IT developments needed to meet the legal requirements are costly and mostly time-consuming.

At this stage of the legislative package, insurers face the same challenges as other financial service providers, due to the horizontal nature of the regulations. It is a complex package of legislation that is even more intricate in its structure and language than the 'usual' EU legislation, and its interpretation poses challenges for the markets. The individual legislative elements are also not aligned with one another in terms of temporal scope, while the 'staged' completion of the regulatory package is also a problem.

¹⁶ *Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting*

The presence of these shortcomings is natural in view of the fact that the SFDR is being phased in progressively and is currently at an early stage. At the same time, it is essential that insurers recognise the potential of ESG products in due time, which, in addition to the SFDR, will hopefully be effectively supported against the risk of 'greenwashing' by the detailed definition system of the Taxonomy Regulation.

Insurers anticipate an increasing trend in the proportion of sustainable products, accompanied by an increase in consumer awareness in the longer term. Customers may develop new target market needs, to which insurers must respond with new solutions. 'More sustainable' business solutions may have a greater customer appeal, and the integration of environmental and social aspects into corporate governance practices may increase the satisfaction of the insurer's employees and customers.

7. Summary

The issue of sustainability in the insurance sector is reflected in the regulations both at the level of institutions and for customers. This will enable buyers of unit-linked insurance to identify, interpret and assess sustainability risks (in a manner equivalent to the risk associated with other investments) and to manage their investments on this basis. In addition, customers will be able to express their ESG preference and facilitate the transfer of capital towards sustainable enterprises, taking into account these considerations in their investment decisions. The primary objective of the SFDR is to assist customers in obtaining transparent, unambiguous information on the sustainability characteristics of investments.

The classification of investments is also of paramount importance from the point of view of analysis, as it provides an opportunity to examine sustainable investment products. Regarding asset funds available in Hungary, in most cases, the annual cost indicator of ESG funds, representing the cost of asset management, is higher compared to the equivalent indicator for non-ESG funds. There may be several reasons for this; accordingly, in addition to higher costs, increasing customer interest may also be factored into pricing.

While the regulations are essentially timely and necessary, they will be applied in progressive stages over time; in addition, some of the regulations promoting further sustainable financing in the EU have not yet come into force, whereby in the present circumstances the SFDR alone is not sufficient to address the challenges identified. Therefore, one of the primary tasks for regulators is to facilitate the adaptation and sustainability turnaround of financial market participants, in this case insurance companies, as much as possible during the transitional period.

Thus, the legislation is not sufficient in its current state, but its existence is absolutely necessary. As regulation evolves and over time, the concerns identified are expected to be overcome and, ultimately, ensure that capital market resources actually flow towards a sustainable economic transition.

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